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Comparing Empirical Results of Transaction Avoidance Rules Studies

ABSTRACT

Empirical legal research in the UK and in the Netherlands has provided data on the extent to which the transaction avoidance rules (avoidance powers, *actio Pauliana*) generate practical problems. This article's goal is to explore the similarities and differences of the data. To achieve this, existing empirical data found in the Dutch and the UK research are compared.

From the comparison, it follows that the UK and The Netherlands share similar problems, i.e. there are no proceeds in a substantial number of cases in which the office-holder (or liquidator) encounters a suspect transaction, the majority of the disputes are conducted in the shadow of the law, proceeds are obtained more often from settlements than from proceedings, insufficient funds and evidence problems are experienced as major obstacles for successfully invoking the transaction avoidance rules, and a presumption or shift of burden of proof influences the outcome significantly.

1. INTRODUCTION AND APPROACH

1.1 Introduction

If a company strives to survive financial difficulties, some creditors often protect themselves at the expense of other, less powerful creditors. For example, security rights will be granted to powerful creditors in order to reassure them. Occasionally, such a transaction can be detrimental to creditors.

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Transaction avoidance rules (avoidance powers, actio Pauliana) provide criteria for qualifying transactions that are detrimental to the interests of creditors. If the criteria for permissibility are not satisfied, the transaction is reversed in order to restore the position of the estate. Most law systems have adopted and implemented transaction avoidance rules.¹

1.2 Research field and research question

Many studies have been conducted with regard to transaction avoidance rules. The majority of the studies concern descriptions of, or comments on, current law. This unquestionably applies to UK², German³ and Dutch⁴ law. They are generally written in the language of this system, e.g. English, German, or Dutch.

Studies that have addressed other issues, for example the rationale, are scarce. Several attempts have been made to justify the existence of transaction avoidance rules. The “pari passu” principle is often considered as the underlying principle of the transaction avoidance rules.⁵ Jackson⁶, however, used the creditors’ bargain theory to

¹ For examples, see P.R. Wood, *Principles of International Insolvency Law*, Sweet & Maxwell: London 2007, pp. 470-471 and pp. 523-538. See also the special issue of the *International Insolvency Review* (2000, Vo. 9, nr. 1), which contains descriptions of transaction avoidance rules in various countries, such as Australia, Germany, The Netherlands, and South Africa.

² For example, L. Sealy, D. Milman, *Annotated Guide to the Insolvency Legislation 2006/2007*, vol. 1, Sweet & Maxwell 2006, pp. 257-276; H. Bennett, J. Armour (eds.), *Vulnerable transactions in corporate insolvency*, Oxford: Hart 2003; Ian F. Fletcher, *The law of insolvency*, London: Sweet & Maxwell 2002; Andrew Keay, ‘Transactional avoidance: critical aspects of English and Australian law’, in: Ian F. Fletcher (Ed.), *International Insolvency Review*, Vo. 9, 2000/1, pp. 5-36; Ian F. Fletcher, ‘Voidable transactions in bankruptcy: British law perspectives’, in: Jacob S. Ziegel (ed.), *Current developments in international and comparative corporate insolvency law*, Oxford: Clarendon Press 1994. For a more reflective approach, see R.M. Goode, *Principles of corporate insolvency law*, London: Sweet & Maxwell 2005, p. 409-509.

³ For example, D. Eickmann et al., *Heidelberger Kommentar zur Insolvenzordnung*, Heidelberg: C.F. Müller Verlag 2003; H. Hess et al., *Kommentar zur Insolvenzordnung: band 1 Insolvenzordnung*, Heidelberg: Müller Verlag 2001; G. Kuhn et al., *Konkursordnung: Kommentar*, München: Vahlen 1994; W. Uhlenbruck, *Das neue Insolvenzrecht: Insolvenzordnung und Einführungsgesetz nebst Materialien: mit Praxishinweisen*, Herne/Berlin: Verlag für die Rechts- und Anwaltspraxis 1994; V Gessner et al., *Die Praxis der Konkursabwicklung in der Bundesrepublik Deutschland: eine rechtssoziologische Untersuchung*, Köln: Bundesanzeiger Verlagsges.mBH 1978.

⁴ For example N.J. Polak, M. Pannevis, *Faillissementsrecht*, Deventer: Kluwer 2005; B. Wessels, *Insolventierecht. Deel III. Gevolgen van faillietverklaring (2)*, Deventer: Kluwer 2003; F.P. van Koppen, *Actio pauliana en onrechtmatige daadvordering* (diss. Tilburg), Kluwer: Deventer 1998; A. van Hees, ‘Voorwaarden voor het instellen van de Pauliana’, in: L. Timmerman (red.), *Vragen rond de faillissementspauliana*, Deventer: Kluwer 1998, pp. 1-11; J.J. van Hees, ‘Enkele Pauliana-perikelen’, in: S.C.J.J. Kortmann et al. (eds.), *Onderneming en 5 jaar Nieuw Burgerlijk Recht*, Deventer: Tjeenk Willink 1997, pp. 567-576;

⁵ For example, R.M. Goode, *Principles of corporate insolvency law*, London: Sweet & Maxwell 2005, p. 411-413, who also considers unjust enrichment and deterrence as underlying policies of the transaction avoidance rules. Other sources are R.J. Mokal, *Corporate insolvency law: Theory and application*, Oxford: Oxford University Press 2005; N.J. Polak, M. Pannevis, *Faillissementsrecht*, Deventer: Kluwer 2005, pp. 98-99; B. Wessels, *Insolventierecht. Deel III. Gevolgen van faillietverklaring (2)*,

explore and define the rationale of the transaction avoidance rules. In short, this theory explains bankruptcy as if it were the most efficient mechanism that creditors would develop if there were no bankruptcy rules.

On an international level, comparative research has been done. In a special issue of the *International Insolvency Review*, different authors described the transaction avoidance rules that have been adopted by Australia, the UK, Germany, The Netherlands, and South Africa.⁷ A similar inventory was made for the transaction avoidance rules in various countries, and principles were derived from the studies.⁸ For example, the *Legislative Guide on Insolvency Law*, published in 2005 by Uncitral, includes an overview of different types of transaction avoidance rules that are commonly used in various countries.⁹ In addition, this report reflects on these rules by outlining experiences with certain types of rules. The experiences are based on observations of individual reporters in the various countries.

The purpose of this research was “to assist the establishment of an efficient and effective legal framework to address the financial difficulty of debtors”. Therefore, it should be used “as a reference by national authorities and legislative bodies when preparing new laws and regulations or reviewing the adequacy of existing laws and regulations”.¹⁰

The *Uncitral Guide*¹¹ commences by stating there are substantial differences between insolvency laws with regard to how the rules are defined and how they are combined. Rather than describing the different rules, the *Guide* reduces them to two types of criteria, viz., objective and subjective criteria. Objective criteria are defined as general(ized) criteria that may be easier to apply than criteria that rely upon knowledge or intentions. According to the *Guide*, objective criteria can produce arbitrary results if relied upon exclusively. For example, if suspect periods are applied in a law system, a proper transaction that falls within a specified period might be

Deventer: Kluwer 2003; J.B. Huizink, *Insolventie*, Deventer: Kluwer 2002, p. 80; G.W. van der Feltz, *Geschiedenis van de Wet op het faillissement en de surséance van betaling* (deel I), Haarlem: Erven F. Bohn 1896, p. 433.

⁶ T.H. Jackson, ‘Avoiding powers in bankruptcy’, 36 *Stan. L. Rev.* 725 (1984), nos. 727-728.

⁷ I.F. Fletcher (Ed.), *International Insolvency Review*, Vol. 9, 2000/1.

⁸ P.R. Wood, *Principles of International Insolvency Law*, Sweet & Maxwell: London 2007 pp. 458-538; W.W. McBryde et al., *Principles of European insolvency law*, Deventer: Kluwer 2003, pp. 53-57.

⁹ Uncitral, *Legislative Guide on Insolvency Law*, New York 2005, <http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf> (last accessed on 2th April 2008).

¹⁰ Uncitral, *Legislative Guide on Insolvency Law*, New York 2005, p. 1.

¹¹ Uncitral, *Legislative Guide on Insolvency Law*, New York 2005, p. 137-141.

voided. On the other hand, preferential transactions that fall just outside this period are protected.

Examples of subjective, case-specific criteria are the intent of the parties to the transaction, the financial circumstances of the debtor at the time the transaction occurred, the financial effect of the transaction on the debtor's assets and what might constitute the normal course of business between the debtor and particular creditors. According to the researchers, evidence problems are often related to subjective criteria. For instance, it is difficult to prove the debtor's or the counterparty's intention.

Therefore, the *Guide* advises to combine both objective and subjective criteria. For example, "suspect periods" could be defined in which it is presumed that the debtor or his counterparty has the knowledge that is required to successfully void a transaction. Additionally, the drafters note that funding difficulties can obstruct the application of transaction avoidance rules. In legal systems where the assets of the debtor provide funds for legal proceedings, lack of funds can prevent the liquidator from instigating legal proceedings.

The information that the *Uncitral Guide* provides is, however, general and abstract. It particularly focuses on types of criteria and their general implications. Neither the *Guide* nor other comparative studies provide quantitative or other, more specific qualitative data that support their findings. As a result, it remains unclear to what extent transaction avoidance rules generate practical problems. This paper addresses the question to what extent transaction avoidance rules generate practical problems. In order to answer this question, empirical data are required.

1.3 Approach

Recently, the application of the Dutch transaction avoidance rules has been studied empirically.¹² The study focused on the results (proceeds) of settlements and proceedings, and on the problems that occur if the rules are applied in practice. As UK research also provides empirical data¹³, a comparison can be made of the existing empirical studies.

¹² G. van Dijk, *De Faillissementspauliana: Revisie van een relict*, Nijmegen: Wolf Legal Publishers 2006.

¹³ D. Milman & R. Parry, 'A study of the operation of transactional avoidance mechanisms in corporate insolvency practice', *ILA Research Report*, 1998.

The comparison will concentrate on the incidence of suspect transactions, settlements and avoidance litigation and the difficulties that office-holders (or liquidators) experience if they encounter a suspect transaction, including the incidence and reasons for not initiating legal proceedings, evidential difficulties and disputes that take place between the liquidator and the counterparty.

Firstly, however, the transaction avoidance rules of UK and Dutch law will be described. A proper understanding of the UK and Dutch transaction avoidance rules is required in order to place the empirical results in the correct legal context. The description is followed by an analysis of the results that the UK and Dutch empirical studies have produced. Such an analysis will provide more detailed information in addition to the remarks and conclusions that were produced in earlier studies, particularly the *Uncitral Guide*.

2. METHODOLOGY OF THE EMPIRICAL DATA COLLECTED

2.1 United Kingdom (UK)

In the UK, a need was felt for empirical data with regard to the transaction avoidance rules.¹⁴ However, the court service has not collected data on transactional avoidance orders. In addition, the Insolvency Service offers no insight into how the transaction avoidance rules are applied. Therefore, in 1996, the researchers turned to practitioners to examine how the law was being operated in practice, emphasizing the limitations of collecting perceptions of practitioners.¹⁵

With the moral (and financial) support of the Insolvency Lawyers' Association, a questionnaire was directed to 555 practitioners, both lawyers and accountants. When the questionnaire asked for indications concerning frequencies, for example as to the incidence of avoidance proceedings, five different categories were distinguished, viz., 'usually' (70-100% of cases), 'often' (40-69%), 'sometimes' (10-39%), 'rarely' (9% or fewer) and 'never' (0%).

The response rate of the survey was 26% (n=143). If the number of practitioners is added who said they were unable to participate, the response rate nears 40%. In addition, approximately 30 interviews were held with leading practitioners

¹⁴ D. Milman & R. Parry, 'A study of the operation of transactional avoidance mechanisms in corporate insolvency practice', *ILA Research Report* 1998, p. 5.

¹⁵ D. Milman & R. Parry, 'A study of the operation of transactional avoidance mechanisms in corporate insolvency practice', *ILA Research Report* 1998, pp. 5-6 and p. 22.

from various parts of the country. Provisional conclusions were successively tested by means of interviews and written consultation.

2.2 *The Netherlands (NL)*

Luttikhuis and the Statistics Netherlands (*Centraal Bureau voor de Statistiek; CBS*) have studied the completed case administrations of 2004.¹⁶ Consequently, the study consisted of a total of 4,165 bankruptcy files, 3,086 of which concerned legal entities and 1,079 of which involved natural persons.

A second empirical study addressed the question to what extent the application of the Dutch transaction avoidance rules have led to practical problems.¹⁷ This study was conducted in 2005 and consisted of a survey and three focus groups which consisted of practitioners specialised in insolvency. After two reminders, the survey response rate was 33%: 173 of the 530 practitioners that were approached responded. Most of the respondents (73%) acted as an office-holder (or liquidator) and as an advisor or an attorney of a counterparty on a regular basis. One quarter had experience purely as an office-holder (or liquidator), merely 2% as an advisor or an attorney.

The survey in this empirical study first addressed the question of whether the practical problems that were found, were related to the application of the rules or to externalities, for instance, a lack of funding. It was expected that a substantial part of the problems could be related to the application of the rules. Therefore, subjects had, among other things, to assess on a five-point scale to what extent the criteria cause evidence problems and disputes. In addition, it was possible for the respondents to add other problems they had experienced in practice.

The survey was followed by focus group research. In three groups, the problems that were identified in the survey were further explored. The groups consisted of eight, nine and six experts on the topic, respectively. The participants were chosen based on their experience in the field of bankruptcy law: two groups consisted of experienced practitioners and one group of practitioners with relatively little experience. To optimize the data that were collected in the focus groups, the results were presented to a group of practitioners that did not participate in the focus

¹⁶ A.P.K. Luttikhuis, R.E. Timmermans, *Insolventierecht in cijfers en modellen: schuldeisersbenadeling en conclusies*, Den Haag: BJU 2007.

¹⁷ G. van Dijck, *De Faillissementspauliana: Revisie van een relict*, Nijmegen: Wolf Legal Publishers 2006.

groups. A total of eight practitioners responded, two of whom had not participated in the survey. In general, all eight practitioners affirmed the outline of the results. Some had different experiences or comments with respect to parts of the results.

3. TRANSACTION AVOIDANCE RULES

3.1 UK Law

The Insolvency Act 1986 (IA 1986) contains, in essence, four grounds to challenge transactions that are detrimental to creditors. The first ground can be found in s. 238 and s. 339 IA 1986. These provisions concern transactions at an undervalue, i.e. gifts, transactions with a gift element and other transactions in which the debtor received a consideration of a value considerably less than that which he gave.¹⁸ To challenge a transaction at undervalue with s. 238/339 IA 1986, it must have occurred in a fixed period before bankruptcy. In case of corporate insolvency, the period is two years before the onset of insolvency (often the onset of the insolvency procedure).¹⁹ The period is five years before the bankruptcy filing in case of personal bankruptcy.²⁰ In addition, s. 240(2) IA 1986 requires that the debtor was unable to pay his debts at the time of the transaction. If these criteria are satisfied, a court order will be made, unless (1) there were reasonable grounds for believing the transaction to benefit the company and (2) the company which entered into the transaction did so in good faith and for the purpose of carrying on its business.²¹

Secondly, in appropriate circumstances transactions at an undervalue can be challenged using s. 423 IA 1986. This section contains rules on transactions that defraud creditors. It can be seen as a complement to s. 238 IA 1986 in attacking transactions at an undervalue as s. 423 IA 1986 does not require that the transaction has taken place in a fixed period. Instead, it requires a purpose to prejudice creditors. Therefore, the wider scope of s. 423 compared to s. 238 is restricted by the requirement of ‘a purpose to prejudice’.

The third ground to challenge transactions that are detrimental to creditors is stated in s. 239 (and s. 340) IA 1986. To successfully challenge a preference, a factual

¹⁸ For references to case law, see L. Doyle, A. Keay, *Insolvency Legislation: Annotations and Commentary*, Jordan Publishing: Bristol 2006, pp. 294-296, and R. Parry, *Transaction avoidance in insolvencies*, New York: Oxford University Press 2001, p. 72.

¹⁹ S. 240(1)(a) IA 1986.

²⁰ S. 341(1)(a) IA 1986.

²¹ S. 238(5) IA 1986.

preference is required. This type of preference can be described as a transaction which places a creditor, surety or guarantor in a better position than the person would have been in if the preference had not been given.²² In addition, to successfully void a preference, the transaction must have occurred six months before the onset of insolvency²³, and the debtor must have had the intention to prefer at the time of the preference²⁴. In corporate insolvency, if a preference is given to a person connected with the company, the company is presumed to have had this intention unless it is proved that this was not the case.²⁵

Cases in which a transaction was most readily seen as preferential were those in which the counterparty was a person connected with the company.²⁶ Therefore, s. 239 IA 1986 is often successfully applied to cases where a company reimbursed the loan that was provided by a director of the company.²⁷

In other cases, a desire is seldom assumed. For example, if the counterparty exerts pressure on the debtor²⁸ or if the preference takes place within the framework of a reorganisation process,²⁹ it is probable that a court will not assume an intention to prefer. In other words, a plausible explanation for the transaction will often lead to the conclusion that the transaction was not preferential.³⁰ Consequently, only three reported cases exist in which a court has considered a preference to be in favour of a person other than a connected person.³¹

²² S. 239(4) IA 1986.

²³ S. 240(1)(a) IA 1986. Two years if the counterparty is a connected party, see s. 240(1)(b).

²⁴ Bennett et al., *Vulnerable transactions in corporate insolvency*, Oxford: Hart 2003; Ian F. Fletcher, *The law of insolvency*, London: Sweet & Maxwell 2002, p. 160. See also *Wills v Corfe Joinery Ltd* [1998] 2 BCLC 75.

²⁵ For details, see *Tesco Supermarkets Ltd v Natrass* [1972] AC 153, HL. The expression “person connected with the company” is defined by s. 249 in conjunction with s. 435.

²⁶ For references to cases, see L. Sealy, D. Milman, *Annotated Guide to the Insolvency Legislation 2006/2007*, vol. 1, Sweet & Maxwell 2006, p. 263.

²⁷ L. Doyle, A. Keay, *Insolvency Legislation: Annotations and Commentary*, Jordan Publishing: Bristol 2006, p. 300; Bennett et al., *Vulnerable transactions in corporate insolvency*, Oxford: Hart 2003; I.F. Fletcher, *The law of insolvency*, London: Sweet & Maxwell 2002, p. 140. For examples, see *Re Lewis v DKG Contractors Ltd* [1990] BCC 903; *Re Exchange Travel Holdings Ltd* [1996] 2 BCLC 524; *Wills v Corfe Joinery Ltd* [1998] 2 BCLC 75; *Re Brian D Pierson (Contractors) Ltd* [2001] 1 BCLC 275.

²⁸ R. Parry, *Transaction avoidance in insolvencies*, New York: Oxford University Press 2001, p. 156. See also *Re MC Bacon Ltd* [1990] BCC 78.

²⁹ *Re Lewis's of Leicester Ltd* [1995] BCC 514.

³⁰ L. Doyle, A. Keay, *Insolvency Legislation: Annotations and Commentary*, Jordan Publishing: Bristol 2006, p. 299; R. Parry, *Transaction avoidance in insolvencies*, New York: Oxford University Press 2001, p. 155. See also *Re Fairway Magazines Ltd* [1992] BCC 924: ‘If the company is influenced by “proper commercial considerations” and not by a “positive wish to improve the creditor's position in the event of its insolvent liquidation”, then the debenture will be valid.

³¹ L. Doyle, A. Keay, *Insolvency Legislation: Annotations and Commentary*, Jordan Publishing: Bristol 2006, p. 299, referring to *Re Living Images Ltd* [1996] BCC 112; *Re Agriplant Services Ltd* [1997]

The fourth ground can be found in s. 245 IA 1986. This section provides rules for attacking floating charges: a charge that is created in favour of a person who is connected with the company can be challenged if it was entered into two years before the onset of insolvency. In addition, the charge must have been created within twelve months of the onset of insolvency. Moreover, the debtor must be insolvent (i.e. unable to pay his debts or becomes unable to pay his debts as a result of the transaction) at the time the charge is created in order to void a (dis)charge.

In addition to the provisions that were described, the IA 1986 contains provisions for attacking specific transactions, for instance, extortionate credit transactions (s. 244 IA 1986) and unenforceability of liens on a company's books or other records (s. 246 IA 1986). A discussion of these provisions is beyond the scope of this paper/article.

If the criteria of s. 238 or 239 are satisfied, a court might make any order that restores the financial position of the debtor to what it would have been had the transaction had not taken place.³²

3.2 *Dutch Law*

The Dutch Bankruptcy Act (DBA; *Faillissementswet*) provides two grounds for voiding a transaction that parties entered into before bankruptcy. The first ground (art. 42 DBA) requires the office-holder (or liquidator) to prove that:

- (1) the transaction is a 'voluntary transaction' (art. 42 DBA), i.e. there was no legal obligation for the transaction or the transaction was not due at the time of the transaction.
- (2) the transaction prejudiced creditors. Examples of transactions that prejudice creditors are a gift, a transaction at undervalue (i.e. the value of the property sold exceeds the selling price or the purchase price of the property bought exceeds the actual value of the property), and a payment that was not due at the time the creditor was compensated. To determine whether a transaction was detrimental to the creditors, a comparison must be made between the actual situation and the hypothetical situation in which the transaction would

BCC 842; *Re Mistral Finance Ltd* [2001] BCC 27. See also R. Parry, *Transaction avoidance in insolvencies*, New York: Oxford University Press 2001, p. 126.

³² Ss 238(3) and 239(3).

not have taken place.³³ Moreover, the loss as a result of the transaction must have been established at the time the court renders its judgment.³⁴

- (3) at the time of the transaction, the debtor and counterparty knew or should have known that prejudice to creditors would be the consequence of the transaction (hence referred to as: knowledge of prejudice to creditors). This implies that the office-holder (or liquidator) has to prove that the debtor had financial difficulties at the time of the transaction. In addition, it is required that the counterparty was aware of or, in all fairness, should have been aware of these difficulties. There is a discussion in the Dutch literature on the extent to which the debtor should have financial difficulties.³⁵ Empirical research demonstrates that most of the office-holders (or liquidators) assume that it is required that the bankruptcy of the debtor is imminent in order to prove the knowledge that is required by the law.³⁶ Knowledge of prejudice to creditors is presumed if the transaction took place one year before the debtor went bankrupt. This presumption specifically applies if insiders are involved or if the transaction is a transaction at an undervalue (s. 43 and 45 DBA).

The second ground can be found in art. 47 DBA. This section states that an ‘obligatory transaction’, for example a payment, is not permissible if the counterparty, at the time of the transaction, has knowledge of the bankruptcy filing of the debtor *or* the debtor and his counterparty colluded to favour this creditor over other creditors (collusion criterion). Case law of the Dutch Supreme Court demonstrates that the collusion criterion focuses on the actual intentions of parties and (therefore) has to be interpreted restrictively.³⁷ Moreover, it indicates that the sole situation in which the collusion criterion can be successfully invoked is in the case that person X has

³³ HR 19 oktober 2001, *NJ* 2001, 654 (*Diepstraten/Gilhuis q.q.*).

³⁴ HR 19 oktober 2001, *NJ* 2001, 654 (*Diepstraten/Gilhuis q.q.*); HR 22 september 1995, *NJ* 1996, 706 (*Ravast/Ontvanger*); HR 23 december 1949, *NJ* 1950, 262 (*Boendermaker/Schopman*). B. Wessels, *Insolventierecht. Deel III. Gevolgen van faillietverklaring (2)*, Deventer: Kluwer 2003, par. 3077 ff; N.J. Polak, M. Pannevis, *Faillissementsrecht*, Deventer: Kluwer 2005, p. 104; F.P. van Koppen, *Actio pauliana en onrechtmatige daadvordering*, Kluwer: Deventer 1998, pp. 91-92.

³⁵ L.J. van Eeghen, *Het schemergebied vóór faillissement*, Den Haag: Boom 2006, pp. 13-14 and p. 132 ff; R.J. de Weijs, ‘Overwaardearrangementen, de actio Pauliana en de verdeling van zure vruchten’, *WPNR* 6652 (2006), p. 86; N.E.D. Faber, *Verrekening*, Deventer: Kluwer 2005, p. 328; N.W.M. van den Heuvel, *Zekerheid en voorrang*, Den Haag: Boom 2004; R.M. Wibier, ‘De centrale plaats van de wetenschap in de Pauliana’, *WPNR* 6548, p. 732; F.P. van Koppen, ‘Zekerheidsrechten en faillissementspauliana’, in: J.C. van Apeldoorn et al., *Onzekere zekerheid*, Kluwer: Deventer 2001, p. 17.

³⁶ G. van Dijk, *De faillissementspauliana: revisie van een relict*, Nijmegen: Wolf Legal Publishers 2006, p. 79.

³⁷ HR 29 juni 2001, *NJ* 2001, 662 (*Meijs q.q./Bank of Tokyo*); HR 20 november 1998, *NJ* 1999, 611 (*Verkerk/Tiethoff q.q.*); HR 24 maart 1995, *NJ* 1995, 628 (*Gispen q.q./IFN*).

considerable or decisive influence on the counterparty as well as on the debtor (both of which are often companies).³⁸

If the criteria of art. 42 or 47 DBA are satisfied, the transaction is considered to be voidable. The current law states in art. 51 DBA that the legal effect of a transaction that can be qualified as not permissible is to restore the ‘old’ situation (before the transaction) by nullifying the transactions that parties entered into.

4. EMPIRICAL RESULTS

4.1 Incidence of suspect transactions

Results

In the UK study, office-holders (or liquidators) were requested to specify how often they had encountered suspect transactions. The results indicate that a majority of the office-holders (or liquidators) (79%-93%) encountered suspect transactions sometimes or rarely (Table 1).

Table 1: Incidence of suspect transactions (UK)

	<i>Never (0%)</i>	<i>Rarely (9% or fewer)</i>	<i>Sometimes (10-39%)</i>	<i>Often (40-69%)</i>	<i>Usually (70-100%)</i>
Section 238 (transactions at undervalue)	1%	44,7%	48,5%	4,9%	1%
Section 239 (preferences)	1%	23,1%	56,7%	15,4%	3,8%
Section 245 (floating charges)	20,8%	67,3%	10,9%	1%	0%
Section 423 (transactions defrauding creditors)	12,5%	59,6%	25%	2,9%	0%

Source: Milman/Parry 1998

In the empirical study that was conducted in The Netherlands, the results demonstrate that office-holders (or liquidators) encountered a suspect transaction in 9% (companies) and 6% (natural persons) of the bankruptcy cases (Table 2).³⁹

Table 2: Incidence of suspect transactions (NL)

³⁸ HR 7 maart 2003, *NJ* 2003, 429 (*Cikam/Siemon q.q.*).

³⁹ A.P.K. Luttikhuis, R.E. Timmermans, *Insolventierecht in cijfers en modellen: schuldeisersbenadeling en conclusies*, Den Haag: BJU 2007, p. 16.

	<i>Suspect transactions (percentage)</i>
Companies	9%
Natural persons	6%

Source: Luttikhuis/CBS 2007

Analysis

A conceivable explanation to interpret the differences which were observed is related to methodological issues. A comparison of the research that studied the Dutch bankruptcy files and the focus group research regarding the Dutch transaction avoidance rules demonstrates that office-holders (or liquidators) estimate the incidence higher than it actually is.⁴⁰ In the focus group research (Van Dijck 2006), office-holders (or liquidators) estimated that they encounter suspect transactions in 30% of the bankruptcies. The bankruptcy files study, however, reveals that the actual percentage is significantly lower (6% and 9%). Therefore, the UK results arguably show inaccurate estimations, i.e. the actual incidence is lower than estimated by the respondents. If this presumption proves to be correct, it is probable that the incidence of suspect transactions in the UK is similar to the incidence in The Netherlands.

4.2 Outcomes

Results

Additionally, Dutch empirical research provides data regarding the outcome of cases in which the office-holder (or liquidator) encountered a suspect transaction. The study demonstrates that a suspicion by the office-holder (or liquidator) led to proceeds in very few cases and that there are no proceeds in a majority of the cases (67% of companies and 81% of natural persons). If there are proceeds in a corporate bankruptcy (n=189), they are mostly based on a settlement in 77% (n=145) of the cases and from a legal procedure in only 23% (n=44) (Table 3).⁴¹

Table 3: Outcome if office-holder (or liquidator) encountered a suspect transaction (NL)

⁴⁰ This conclusion is based on notes taken during the focus groups research. These notes can be requested by contacting the author of this paper.

⁴¹ A.P.K. Luttikhuis, R.E. Timmermans, *Insolventierecht in cijfers en modellen: schuldeisersbenadeling en conclusies*, Den Haag: BJU 2007.

<i>Action office-holder (or liquidator)</i>	<i>Companies</i>	<i>Natural persons</i>
Settlement	25%	11%
Legal procedure with proceeds	8%	8%
Legal procedure without proceeds	6%	8%
No legal action, recovery is unlikely	29%	36%
No legal action, insufficient funds	15%	12%
No legal action, other reason	17%	25%
<i>Total</i>	<i>100%</i>	<i>100%</i>

Source: Luttikhuis/CBS 2007

Under the IA 1986, proceeds are also obtained more often from settlements than from proceedings. According to half of the UK practitioners, disputes are settled in a majority of cases (Table 4).

Table 4: Use of settlements (UK)

	<i>Rarely (9% or fewer)</i>	<i>Sometimes (10-39%)</i>	<i>Often (40-69%)</i>	<i>Usually (70-100%)</i>
Section 238 (transactions at undervalue)	9,4%	18,9%	15%	56,6%
Section 239 (preferences)	9,3%	16,7%	14,8%	59,3%
Section 245 (floating charges)	13,9%	19,4%	16,7%	50%
Section 423 (transactions defrauding creditors)	21%	21%	14,8%	43,2%

Source: Milman/Parry 1998

In case of litigation (Table 3), more than half of the respondents (50%-60%) indicate that they bring a case to trial sometimes or rarely (Table 5).

Table 5: Incidence of avoidance litigation (UK)

	<i>Rarely (9% or fewer)</i>	<i>Sometimes (10-39%)</i>	<i>Often (40-69%)</i>	<i>Usually (70-100%)</i>
Section 238 (transactions at undervalue)	38,6%	18,8%	12,9%	29,7%
Section 239 (preferences)	33,7%	22,8%	13,9%	29,7%
Section 245 (floating charges)	50,5%	15,6%	4,6%	29,4%
Section 423 (transactions defrauding creditors)	49,4%	12,9%	10,6%	27,1%

Source: Milman/Parry 1998

In addition, if a case is brought to trial, the matter is often/usually dropped without a settlement, according to 50%-60% of the respondents (Table 6).

Table 6: Incidence of avoidance cases that were dropped without settlement (UK)

	<i>Rarely (9% or fewer)</i>	<i>Sometimes (10-39%)</i>	<i>Often (40-69%)</i>	<i>Usually (70-100%)</i>
Section 238 (transactions at undervalue)	20%	27,3%	41,8%	10,9%
Section 239 (preferences)	19,4%	41,9%	22,6%	19,4%
Section 245 (floating charges)	21,9%	24,4%	36,6%	17,1%
Section 423 (transactions defrauding creditors)	17,4%	21,7%	43,5%	17,4%

Source: Milman/Parry 1998

Analysis

When comparing the two empirical studies, the results demonstrate that most of the disputes are conducted (and settled) in the shadow of the law. Additionally, the results indicate that there are no proceeds in a substantial number (if not the majority) of cases in which the office-holder (or liquidator) encounters a suspect transaction.

4.3 Reasons for not initiating legal proceedings

Results

As can be seen, the majority of cases where the office-holder (or liquidator) encountered suspect transactions does not result in legal proceedings and/or a settlement. Two principal causes can be identified from the UK and Dutch studies for not challenging suspect transactions.

In the UK, lack of funding and evidence problems are important obstacles for successfully attacking a suspect transaction (26%-37%) (Table 7).

Table 7: Reasons for not initiating legal actions (UK)

	S. 238	S. 239	S. 245	S. 423
Lack of funding	63,9%	60,4%	62,3%	60,1%
Lack of evidence	26,4%	28,1%	31,9%	37,3%
Other reason(s)	9,7%	11,5%	5,8%	2,6%

Source: Milman/Parry 1998

In addition, the Luttikhuis/Timmermans study⁴² demonstrates that, in The Netherlands, unlikely recovery is a major cause (ca. 50%) for not initiating a settlement or legal proceedings (Table 8).

⁴² A.P.K. Luttikhuis, R.E. Timmermans, *Insolventierecht in cijfers en modellen: schuldeisersbenadeling en conclusies*, Den Haag: BJU 2007.

Table 8: Reasons for not initiating legal actions (NL)

	<i>Companies</i>	<i>Natural persons</i>
No legal action, recovery is unlikely	48%	47%
No legal action, insufficient funds	25%	18%
No legal action, other reason	27%	35%
<i>Total</i>	<i>100%</i>	<i>100%</i>

Source: Luttikhuis/CBS 2007

The second Dutch empirical study provides similar results (Table 9). However, it also indicates that the expectation that, although recovery is likely, the costs exceed the proceeds, is a major obstacle for successfully voiding suspect transactions (Table 9).

Table 9: Reasons for not initiating legal actions (NL)

	Never / (Very) rarely	Not rarely / not often	(Very) often
Recovery is unlikely	6%	16%	78%
Lack of funding / evidence	21%	25%	55%
The expectation that, although recovery is likely, the costs exceed the proceeds	16%	26%	58%

Source: Van Dijck 2006

In addition to the Luttikhuis/Timmermans research, the second Dutch empirical study indicates that evidence problems are an important obstacle to prevent office-holders (or liquidators) from challenging suspect transactions successfully.⁴³

Analysis

The studies identify the lack of funding and evidential difficulties as a major obstacle for not initiating legal actions. However, insufficient funds is seen as less of a problem in The Netherlands than in the UK. This can partly be explained by the way in which actions are funded. Under the DBA, the costs that the office-holder (or liquidator) makes can be paid as expenses of the winding up of bankruptcies. Under the IA 1986, this was only permitted in certain circumstances.⁴⁴

The Insolvency Rules were changed in 2002, i.e., after the UK study was conducted (1998). Consequently, office-holders (or liquidators) are currently allowed

⁴³ G. van Dijck, *De faillissementspauliana: revisie van een relict* (diss. Tilburg), Nijmegen: Wolf Legal Publishers 2006.

⁴⁴ *Re Floor Fourteen Ltd Lewis v. Inland Revenue Commissioners* [2001] 3 All ER 499.

to charge the costs of insolvency litigation as an expense of winding up.⁴⁵ As a result of this change, the problem of lack of funding may have decreased since the research was conducted.

The problem of unlikely recovery as a major obstacle can easily be explained. Previous to challenging a transaction, the office-holder (or liquidator) will, among other things, verify if it is worthwhile to initiate proceedings. For example, he or she will verify whether recovery is likely and whether the expected proceeds exceed the costs that will probably be made. This investigation can compel office-holders (or liquidators) not to challenge a transaction, even if the transaction was, in their opinion, not permissible.

It is, however, rather remarkable that the UK study does not identify unlikely recovery as an obstacle. By contrast, the problem of unlikely recovery is seen as a major obstacle for successfully invoking the transaction avoidance rules in The Netherlands. Supposedly, respondents in the UK research conceived unlikely recovery as lack of funding.

Notwithstanding methodological differences and the differences in the results, it becomes obvious that the major obstacles for not bringing a case to court are, to a large extent, related to 'externalities' as insufficient funds, unlikely recovery, and a negative cost-benefit ratio. Therefore, it is surprising to observe that the legal doctrine mostly focuses on the transaction avoidance rules and not (or less) on the externalities mentioned. This at least applies to the UK as well as to The Netherlands, and, to my knowledge, also to Belgium and Germany.

4.4 Application problems and difficulties

Although legal scholars mostly focus on the transaction avoidance rules, little is known about to what extent the transaction avoidance rules generate practical problems. The evidence problems and other application problems were further explored in the Van Dijk 2006 study. Because of the (supposed) importance of these application problems and difficulties, it can be considered worthwhile to explore these, even though an UK counterpart of this research is not available.

⁴⁵ Insolvency (Amendment) (No 2) Rules 2002, SI 2002/2712 Sch 1 (2), para 23 amend Insolvency Rules 1986, r 4.218.

General observations

Based on the focus group data of the Dutch empirical research, two important observations can be made for the Dutch transaction avoidance rules. The first concerns the aspect of professionalisation. Banks and large companies are more aware of, and specialized in, the transaction avoidance rules. These creditors can anticipate and effectively neutralise the impact of transaction avoidance by, for example, obtaining security rights outside suspect periods. By contrast, small and medium-sized businesses have no knowledge of the existence of transaction avoidance rules, according to the participants of the focus groups. For these creditors, it is unlikely that the transaction avoidance rules affect their behaviour. Therefore, there is presumably little preventive effect in these cases.

A second important observation is that the criteria are too limited. More specifically, creditors with influence, such as banks or shareholders, determine the direction of the debtor (company) without having to account for influencing or forcing the debtor to do certain transactions. These persons or entities are generally better informed with regard to the financial situation of the debtor than most other creditors.

This specifically applies to banks. Although banks initiate and contribute to successful reorganisations, they often notice, more than other creditors, when bankruptcy is proximate. According to the participants, a bank will then use legal instruments, for example security interests, to secure its own interests. In practice, the debtor and his counterparty create a legal ground for one or more transactions which will take place in the future at a time when the financial situation of the debtor is healthy. The future transaction will then be considered to be obligatory at the time the transaction is carried out.

In The Netherlands, it is common for banks/lenders to oblige the borrower to pledge current as well as future property (art. 20 General Terms and Conditions of the Banks; *Algemene Bankvoorwaarden*). As a result, any subsequent pledges are based on that existing obligation and can only be avoided pursuant to art. 47 DBA. If the debtor (borrower) enters into bankruptcy, such an obligation forces the office-holder (or liquidator) to prove consultation or knowledge of the bankruptcy filing, which is seen as very difficult, in contrast to knowledge of prejudice, which is easier to prove. Consequently, most of the assets in a bankruptcy are allocated to the bank. Due to a

lack of assets in the bankrupt estate, office-holders (or liquidators) do not have enough funds to initiate proceedings or even to liquidate.

The impression in the focus groups was that most of the participants, especially those with experience, urge the legislator to oblige banks (and other creditors with influence) to be held accountable for their actions in the period before the debtor/borrower went bankrupt.

Intentions

In general, the results indicate that if criteria emphasize the intent of the parties to the transaction, this substantially increases the risk of evidential difficulties (Table 10).⁴⁶

Table 10: Office-holders' (or liquidators') perception of evidential difficulties (NL)

	(Very) difficult	(Very) easy
Qualifying a transaction as voluntary or obligatory	7%	69%
Proving that the transaction harmed creditors	20%	39%
Proving collusion	75%	6%
Proving knowledge of prejudicing creditors if a presumption of knowledge is applicable	7%	66%
Proving knowledge of prejudicing creditors when the knowledge is NOT presumed	75%	4%
Proving knowledge of the bankruptcy filing	39%	30%

Source: Van Dijk 2006

Here, the intentions of the parties to a contract have proved to be a deficient basis for assessing the permissibility of the transaction. For instance, it is (very) difficult to prove collusion, according to 75% of the office-holders (or liquidators). This corresponds to the claim of Doyle and Keay, holding that “[i]t is probably notable, and indicative of the difficulty of establishing a desire, that there are apparently only three reported cases in which a court has found there to be a preference in favour of a person other than a connected person”.⁴⁷

⁴⁶ The survey among UK practitioners provides similar results, see D. Milman & R. Parry, ‘A study of the operation of transactional avoidance mechanisms in corporate insolvency practice’, *ILA Research Report*, 1998.

⁴⁷ L. Doyle, A. Keay, *Insolvency Legislation: Annotations and Commentary*, Jordan Publishing: Bristol 2006, p. 299.

Knowledge

The same percentage (75%) applies for proving knowledge of prejudicing creditors if the knowledge that is required is not presumed. However, if knowledge *is* presumed, the opposite applies. The data show that in cases in which knowledge is presumed on a statutory basis (s. 43 DBA), it is (very) easy for 66% of the office-holders (or liquidators) to prove knowledge on the part of the debtor and its counterparty. As a result of the fact that the other party must prove the opposite, it can be concluded that a presumption or shift of the burden of proof will determine the outcome (permissible or not permissible) to a large extent. In other words, the chances of successfully voiding a transaction are substantial if a presumption or shift is applicable and slim if a presumption or shift is not applicable.

The evidential difficulties were further explored in the focus groups. Participants were asked how they prove knowledge (and intentions). They explained that knowledge is often easy to prove if counterparties are connected with or related to the debtor, for instance if the counterparty of the debtor was family or an allied company. However, the earlier the transaction took place, the more difficult it is to prove the knowledge required by the law.

If a presumption is not applicable, office-holders (or liquidators) use (e-mail) correspondence, notes and statements by witnesses, and employees, etc., to prove the knowledge that is required by the law. A majority of the office-holders (or liquidators) that participated in the focus groups can sometimes rely on conversations with, for instance, employees and accountants. Occasionally, prior knowledge is assumed if the transaction can be considered to be unusual. Office-holders (or liquidators) also use this type of information to prove knowledge on the part of the debtor. In case of an 'obligatory' transaction (payments), however, where it is required to prove knowledge of the bankruptcy filing, this type of information is often discovered accidentally. The focus groups data indicate that the success office-holders (or liquidators) achieve with this criterion is generally the result of coincidence (for example, the office-holder (or liquidator) discovers a letter sent by a creditor that provides evidence for a payment that is regarded as not permissible).

Disputes

The Dutch study did not merely focus on evidence problems, but also on the extent to which the Dutch transaction avoidance rules cause disputes. In general, the nature of

the discussions and disputes depends on what type of counterparty the office-holder (or liquidator) faces. In essence, three types can be distinguished: the expert; the attorney who is not specialised in bankruptcy law; and the layman who has no legal expertise. The focus group data indicate that attorneys who are not specialised in the field of insolvency law can be easily persuaded that the transaction is not permissible. Laymen, especially directors of (group) companies, find that in practice they are often forced to make transactions which turn out to be detrimental to creditors (“there were no other options” or “I had to carry out the transaction as part of the reorganisation process”). It is likely they will challenge a claim of the office-holder (or liquidator) if he or she states that the transaction was made voluntarily. Office-holders (or liquidators) consider these types of claim easy to parry.

If the counterparty is assisted by an expert in the field of insolvency law, he will often try to find legal arguments to contend the claim of the office-holder (or liquidator) that the transaction was not obligatory, to show that the creditors’ interests were harmed, and to prove that his client knew or should have known that the transaction would harm creditors. Although office-holders (or liquidators) sometimes encounter significant opposition from an expert, they prefer communicating with this type of counterparty. According to the participants, an expert contributes to channelling the discussion or dispute.

More specifically, it can be concluded that the requirement of knowledge of prejudicing creditors causes the most disputes in comparison to the other requirements (Table 11).

Table 11: Incidence of grounds for disputes (NL)

	Never/not often		(Very) often	
	Office-holders (or liquidators)	Advisors/attorneys	Office-holders (or liquidators)	Advisors/Attorneys
The qualification of a transaction as voluntary or obligatory	37%	28%	36%	51%
Evidence for the transaction harming creditors	14%	7%	60%	64%
Evidence for collusion	30%	45%	37%	25%
Evidence of knowledge for prejudicing creditors	8%	6%	68%	66%
Evidence of knowledge for the bankruptcy filing	41%	54%	23%	15%

Source: Van Dijk 2006

In addition, it is rather remarkable that the qualification of a transaction as voluntary or obligatory gives rise to (relatively) many disputes between the office-holder (or

liquidator) and the counterparty. The focus groups data show that disputes often concern different perceptions of what is obligatory and what is voluntary. More specifically, the legal definition of obligatory and voluntary does not correspond with what, for example, directors of companies consider to be voluntary and obligatory (for instance, a typical defence of an entrepreneur is that the suspect transaction was part of a reorganisation process and that it was, therefore, obligatory).

It is also remarkable that 39% of the office-holders (or liquidators) experience that it is (very) easy to demonstrate that a transaction is detrimental to creditors, while the requirement causes disputes (very) often according to two thirds of the respondents. This oddity was further explored in the focus groups. According to the participants, the evidence of detriment is often arbitrary and, therefore, relatively easy to challenge.

Firstly, the question of whether a transaction prejudices creditors is not purely a mathematical one. The answer to the question of whether a transaction is detrimental to creditors (also) depends on factors such as the probability of the transaction triggering other (positive or negative) events.

Secondly, it is often difficult to determine the value of goods, services and particularly goodwill. For example, surveyors can come to substantially different assessments. As a result, it is difficult to answer the question if a transaction was detrimental to creditors. This point was also noted in the interviews in the UK study, which indicated that the burden of proving undervalue (s. 238 IA 1986) is relatively easy, but that most of the evidential difficulties are caused by establishing a significant undervalue.

Thirdly, in one focus group it was noticed that challenging the proof of detriment is “part of the game”. These three circumstances explain why the requirement of detriment gives rise to a relatively substantial number of disputes.

5. CONCLUSION AND DISCUSSION

The comparison between empirical data from UK and Dutch research provides valuable information regarding the question to which extent the transaction avoidance rules generate practical problems.

5.1 Similarities

The incidence of suspect transactions arguably ranges somewhere between 6%-9% (NL) and 10-40% (UK). Practitioners, however, arguably perceive a higher incidence of suspect transactions than is actually the case. Therefore, it is probable that the incidence of suspect transactions is substantially lower than the alleged 40%.

More striking are the similarities regarding the problems that occur when invoking the transaction avoidance rules in a situation in which a suspect transaction is encountered. In this respect, both the UK and The Netherlands share the difficulty of evidence problems and insufficient funds. These are seen as major obstacles to successfully invoking the transaction avoidance rules. Apart from funding problems, the comparison indicates that if criteria focus on the intent of the parties to the transaction, this significantly increases the risk of evidential difficulties. Therefore, an accumulation of difficulties takes place in which funding problems reinforce evidential difficulties, and vice versa.

Additionally, the majority of the disputes are conducted in the shadow of the (UK and Dutch) law. As a result, proceeds are obtained substantially more frequently from settlements than from proceedings. This finding has an important methodological implication with regard to conducting legal research in the field of transaction avoidance rules, as I will argue (see “methodological implications”).

5.2 Reforming transaction avoidance rules

The solution for the major difficulties in Dutch and UK law is, obviously, to improve insolvency funding and to reduce the office-holder’s (or liquidator’s) burden of proof. With regard to reducing the burden of proof, however, transaction avoidance is a highly delicate matter. On the one hand, one does not want to restrict companies and individuals in conducting transactions that are desirable from an economic point of view. On the other hand, funding problems and evidential difficulties lead to the rules being ineffective, i.e. can hardly be successfully invoked, which implies that transactions that must be considered as “not permissible”, are left untouched.

Although transaction avoidance is a delicate matter, one could (and should) strive to find a balance between avoiding transactions and facilitating economically desirable transactions. A successful method is a shift of the burden of proof. The Dutch data indicate that a presumption or shift of the burden of proof is an effective means to reduce evidential difficulties. For example, in cases of transactions at undervalue (voluntary transactions), evidential difficulties are seen as less of a

problem than in cases of preferences (obligatory transactions). Conversely, the UK data show merely small differences between evidential difficulties regarding preferences and transactions at undervalue. This could imply that the presumption with regard to connected persons works adequately, since connected persons often can induce or even force the debtor to make preferential transactions.

It is evident that reducing evidential difficulties will supposedly have a positive effect on the existing funding problems. A shift of burden, for example, not only improves the office-holder's (or liquidator's) evidential position. It also makes fact finding and procedures less costly.

Obvious and remarkable at the same time is the aspect of insolvency funding. Although funding is considered as a major obstacle for avoidance litigation, very little research has been done in this field. In this respect, I can only refer to one report which provides a global overview of different funding strategies.⁴⁸ Therefore, studies and research regarding the possibilities, effects and results of the various forms of state and private funding can be highly recommended.

5.3 *Final remark*

The preceding conclusions demonstrate that UK and Dutch law share similar difficulties regarding the application of the transaction avoidance rules. This indicates that at least some difficulties are universal and subsistent in transaction avoidance rules. Therefore, a comparative or international approach of transaction avoidance should be encouraged. Consequently, it is not necessary to restrict studies in this field to a specific legal system.

⁴⁸ Assetless Insolvencies Report – January 2005,
<http://www.insolvencyreg.org/sub_publications/docs/IAIR%20Assetless%20Insolvencies%20Report%20V103.pdf>.